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No. 85-519

In The

Supreme Court of the United States

October Term, 1985

DR. WILLIAM C. RANDALL,
DR. ROGER E. AUSTIN,
DR. TOM W. ANDERSON and
DR. MYREL A. NEUMANN,

Petitioners,

v.

B. J. LOFTSGAARDEN; ALOTEL INCORPORATED, a Minnesota corporation; PROPERTY DEVELOPMENT AND RESEARCH COMPANY, a Minnesota corporation; and 2361 BUILDING CORPORATION, a Minnesota corporation,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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QUESTIONS PRESENTED

1. Whether favorable tax consequences to defrauded investors in a limited partnership, together with imputed interest thereon, constitute "income received" which section 12(2) of the Securities Act of 1933 requires be deducted from the consideration paid when the investors' purchase of the securities is rescinded.

2. Whether favorable tax consequences to defrauded investors in a limited partnership, together with imputed interest thereon, are to offset rescissionary damages awarded pursuant to section 10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Commission Rule 10b-5 to insure that the investors do not recover more than "actual damages."

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OPINIONS BELOW

The *en banc* opinion ot the Eighth Circuit and the accompanying panel opinion (hereinafter "*Austin II*") are reported at 768 F.2d 949 and are set forth in Petition Appendix A. The unreported Amended Judgment and the unreported Order of the district court on a remand by the Eighth Circuit on a prior occasion are set forth in Petition Appendices B and C. The earlier opinion of another panel of the Eighth Circuit (hereinafter "*Austin I*") is reported at 675 F.2d 168 and is set forth in Petition Appendix D. The unreported Findings of Fact, Conclusions of Law and Order for Judgment and the Memorandum Order of the district court at the conclusion of the first trial are set forth in Petition Appendices E and F.

JURISDICTIONAL STATEMENT

The judgment of the Court of Appeals for the Eighth Circuit was entered on July 16, 1985. The Petition for a Writ of Certiorari was filed on September 24, 1985, and was granted on November 12, 1985. (J.A.3). This Court's jurisdiction is invoked pursuant to 28 U.S.C. § 1254(1).

STATUTES AND REGULATION

Section 12(2) of the Securities Act of 1933, 15 U.S.C. § 77*l*(2):

> Any person who—
>
> * * *
>
> (2) offers or sells a security . . . by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral com-

> munication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,
>
> shall be liable to the person purchasing such security from him who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b):

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national security exchange—
>
> * * *
>
> (b) To use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5 of the Securities and Exchange Commission, 17 C.F.R. § 240.10b-5:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national security exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,

> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Section 28(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78bb(a):

> The rights and remedies provided by [the Securities Exchange Act of 1934] shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of [the Securities Exchange Act of 1934] shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of the actual damages on account of the act complained of.

STATEMENT OF THE CASE

Petitioners are four investors who purchased one or more units[1] in Alotel Associates, a limited partnership formed to operate a Ramada Inn in Rochester, Minnesota. (Pet.App.D1). Respondents are the individual and corporate general partners of Alotel Associates and their affiliates. (Pet.App.D3-D4).

Respondents distributed an Offering Memorandum to potential investors, including Petitioners. (Pet.App. D7). The Offering Memorandum purported to describe the limited partnership, the Ramada Inn project, the terms available for financing the partnership's activities and the timetable for constructing the Ramada Inn. (Pet.App.D7;

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[1] The price of each unit was $35,000. (Pet.App.D7).

Pl.Ex.2; Tr.42). The Offering Memorandum contained a *pro forma* projection of cash flow, of resale price and anticipated profit at the time of resale and of the tax consequences of a limited partner's investment. (Pl.Ex.2 at 27; Tr.42).

The Offering Memorandum misrepresented the rate and amount of interest to be paid for construction financing, the length of a ground lease, the completion date and the terms of financing available for furnishings and equipment. (Pet.App.D7-D8). The Offering Memorandum described a non-existent commitment for long-term financing. (Pet.App.D8). The Offering Memorandum omitted information about the control which Respondent B. J. Loftsgaarden (hereinafter "Loftsgaarden") exercised over Respondents Alotel Incorporated, Property Development and Research Company (hereinafter "PDRC") and 2361 Building Corporation (hereinafter "2361"), about PDRC's anticipated profits on a sale of land, about a commitment fee to be paid to PDRC, about Loftsgaarden's interest in arc-TECH, inc., a firm which was to design the Ramada Inn and to supervise its construction and about Loftsgaarden, PDRC, 2361 and arc-TECH, inc.'s anticipated profits. (Pet.App.D9, E11).

PDRC received $23,100 as a commitment fee and $57,390 for undisclosed purposes. (Pet.App.E11; Pl.Ex 50; Def.Ex.41A; Tr.371,662). PDRC also earned a profit of between $37,388 and $54,078 on land transactions. (Pet. App.D9,E7; Pl.Ex.51,55,56; Tr.372,398,403-07). 2361 received $35,000 as "contractor's overhead," $23,524 for "reimbursement," $449 for "general contracting services," $3,972 for "contracting work" and $2,349, $63,724 and

$38,041 for undisclosed purposes.[2] (Def.Ex.41B,41C,41E, 41F,41G,41H,41J,41K; Tr.662). Arc-TECH, inc., received $90,000 for its services. (Pet.App.E7,E11).

The limited partners' investments and the available loans proved insufficient to construct and furnish the Ramada Inn. (Pet.App.D10). Alotel Associates had no initial operating capital. Alotel Associates was forced to obtain additional investors. (Pet.App.D10; Pl.Ex.79; Tr. 672-73,693-94). The additional investments proved insufficient, and the business continued to flounder. The investors then made several loans to Alotel Associates.[3] (Pet.App.F12). Alotel Associates ultimately defaulted on its loans and its rental payments, and its creditors foreclosed. (Pet.App.D10; Pl.Ex.46; Tr.348,350,577).

On February 24, 1976, Petitioners and others commenced this action to recover their investments. (J.A.1; D.R.1-10). Their amended complaints alleged that Respondents had violated sections 12(2) and 17(a)[4] of the Securities Act of 1933, 15 U.S.C. §§ 77*l*(2) and 77q(a); section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b); Rule 10b-5 of the Securities and Exchange Commission, 17 C.F.R. § 240.10b-5; and section 1 of the Minnesota Uniform Securities Act, Minn. Stat. § 80A.01 (1978), had committed a fraud under the common law of Minnesota, had been negligent and had breached fiduciary duties to Petitioners.[5] (D.R.219-46,266-74). Petitioners alleged misrepresentations and omissions of material in-

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2 Respondents had anticipated that 2361 would receive $316,572 as "overhead" and "contingency and profit." (Pet. App.E5; Pl.Ex.27 at 2; Tr.305).

3 The total loans "assessed" against each unit was $8,500. (Pl.Ex.34-45; Tr.337,345,497).

4 The district court dismissed Petitioners' section 17(a) claim.

5 Petitioners discontinued their negligence and breach of fiduciary duty claims at trial. (Tr.730).

formation. (DR.219-46,266-74). They sought rescission[6] or damages. (D.R.245-46,273-74).

Respondents denied liability. (D.R.196-218). Respondents argued that reductions in Petitioners' federal and state income tax liabilities which resulted from deductions Petitioners took as a result of operating losses sustained by and depreciation and investment credits attributable to Alotel Associates constituted "income received" and that section 12(2) mandated that "income received" be deducted from any recovery. (Pet.App.F5-F9). They also argued that the tax consequences reduced the "actual damages" to which Petitioners might be entitled under section 10(b) and Rule 10b-5. (Pet.App.F5-F9).

The district court refused Respondents' request to instruct the jury that it might reduce damages by "income tax benefits which [Petitioners had] obtained." (D.R.365; Tr.740-42). Instead, the district court found that "the limited partnership units in Alotel Associates . . . were valueless" at the time Petitioners discovered the fraud. (Pet.App.E13). The district court therefore instructed the jury that Petitioners' damages under section 10(b), Rule 10b-5, Minn. Stat. § 80A.23 and common law fraud would "be equal to the amounts of monies which [Petitioners had] paid out in reliance upon the false representations." (Tr.805). The district court concluded that Petitioners were "entitled to recover the consideration [they had] paid for the limited partnership units" under section 12(2) and held that the "out-of-pocket [and] rescissionary measures [of damages] would yield the same results." (Pet.App.F7). Based upon the jury's verdict and its own findings, the district court awarded Petitioners judgment

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[6] Petitioners had tendered their limited partnership units to Respondents. (Pet.App.D18,E14; Ct.Ex.2,3; Tr.626,629).

in amounts equal to the amounts of their investments plus interest[7] on the amounts of their investments.[8] (Pet.App. E16,F15-F16).

Respondents appealed. (J.A.2). An Eighth Circuit panel affirmed the jury's and the district court's findings of liability, but vacated and remanded to the district court for a new trial on the issue of damages. The panel held that

> in a private securities fraud action involving an investment structured and marketed as a tax shelter, where a rescissory measure of damages is applied, evidence of any benefit derived by the plaintiff/investor via tax savings must be permitted.

Austin I at 183-84. The panel aslo held that "the damage award must be reduced by any value shown to have been received by plaintiffs." *Austin I* at 181.

On remand, the district court stated:

> [T]he starting point for assessing damages will be the amount each plaintiff paid Loftsgaarden for his investment (in other words, the plaintiff's consideration). To this, the court will add 8 percent interest from the date the consideration was paid to the date of this order. Finally, the amount of each plaintiff's tax benefits will be subtracted from the sum of his consideration and interest.

(Pet.App.C5). The district court then made the following calculations and awards:

Plaintiff Anderson	
Consideration paid June 2, 1983:	$35,000.00
Plus interest at 8 percent to February 22, 1984:	$64,787.00
Minus tax benefits:	$29,615.00
Total Damages:	$35,172.00

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7 Interest was awarded pursuant to the statutory mandates in section 12(2) and in Minn. Stat. § 80A.23, subd 2.

8 The district court denied Petitioners a return of their "loans" to Alotel Associates. (Pet.App.A3,D10,E12,F12-F13).

Plaintiff Austin	
Consideration paid June 6, 1983:	$35,000.00
Plus interest at 8 per cent to February 22, 1984:	$64,610.00
Minus tax benefits:	$33,333.00
Total Damages:	$31,277.00
Plaintiff Ne[u]mann	
Consideration paid August 21, 1973:	$35,000.00
Plus consideration paid October 19, 1973:	$17,500.00
Plus interest at 8 percent to February 2, 1984:	$96,385.00
Minus tax benefits:	$57,014.00
Total Damages:	$39,371.00
Plaintiff Randall	
Consideration paid November 13, 1973:	$35,000.00
Plus interest at 8 percent to February 22, 1984:	$63,770.00
Plus consideration paid 1975:	$ 2,512.00
Plus interest at 8 percent to February 22, 1984:	$ 4,203.00
Subtotal:	$67,973.00
Minus tax benefits:	$36,404.00
Total Damages:	$31,569.00

(Pet.App.B1-B2).

Respondents again appealed. (J.A.3). The Eighth Circuit *sua sponte* granted *en banc* consideration as to whether *Austin I* should be reconsidered and as to whether damages had been calculated properly if *Austin I* had been decided properly. *Austin II* at 951. The Eighth Circuit then held that *Austin I* had been decided correctly. To compute the recovery the Eighth Circuit adopted a formula: add interest to the consideration paid for the security, subtract "tax benefits" received and imputed interest thereon, then multiply the difference by two. The Eighth Circuit therefore reduced the awards as follows:

Austin ($7,666), Anderson ($18,790), Neumann ($1,984) and Randall ($506). *Austin I* at 961.

On September 24, 1985, Petitioners filed their Petition for Writ of Certiorari. (J.A.3). On November 12, 1985, this Court granted the Petition. (J.A.3).

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SUMMARY OF THE ARGUMENT

I. In interpreting the federal securities laws, this Court has always started with the statutory language. *See Landreth Timber Co. v. Landreth*, 105 S. Ct. 2297, 2301 (1985); *Teamsters v. Daniels*, 439 U.S. 551, 558 (1979); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 756 (1975) (concurring opinion). The language of section 12(2) of the Securities Act of 1933 [hereinafter "section 12(2)"] does not provide that the recovery of "consideration paid" be reduced by "tax benefits." The "actual damages" limitation of section 28(a) of the Securities Exchange Act of 1934 [hereinafter "section 28(a)"] does not require that "tax benefits" be subtracted from damages awarded under section 10(b) of the Securities Exchange Act of 1934 [hereinafter "section 10(b)"] and Securities and Exchange Commission Rule 10b-5 [hereinafter "Rule 10b-5"]. The Eighth Circuit strayed from the appropriate starting point when it deducted "tax benefits" from recoveries under such statutes.

The Eighth Circuit first strayed from the statutory language by distinguishing between "tax shelters" and other securities and by adopting a rule which applies only to "tax shelters." Section 12(2), section 10(b), Rule 10b-5 and section 28(a) apply to *all* securities. There is no sta-

tutory language on which a special rule applicable only to "tax shelters" might be based.

The Eighth Circuit next strayed from the statutory language by defining "income received" to include "tax benefits." In *United Housing Foundation, Inc. v. Forman,* 421 U.S. 837, 855 (1975), this Court held that "payment of interest, with its consequent deductibility for tax purposes," did not constitute income within the context of the federal securities laws. In fact, "income" is

> compensation for services, . . . gross income derived from business, gains derived from dealings in property, interest, rents, royalties, dividends, . . . income from discharge of indebtedness [and] distributive share of partnership gross income.

26 U.S.C. § 61. "Tax benefits" are not included in the plain language of the statutory definition of "income." "Income" is taxable. *See* 26 U.S.C. §§ 1 & 11. "Tax benefits" are not. Because "tax benefits" are not "income," they should not be deducted from "consideration paid" when calculating the recovery available to a defrauded investor under section 12(2).

The Eighth Circuit also strayed from the statutory language by awarding interest on the "tax benefits." Such an award rewrites "the remedial language of the statute." *Johns Hopkins Univ. v. Hutton,* 297 F. Supp. 1165, 1231 (D. Md. 1968), *rev'd on other grounds,* 422 F.2d 1124 (4th Cir. 1970), *cert. denied,* 416 U.S. 916 (1974). Section 12(2) provides only for adding "interest" to the "consideration paid." The courts are not free to substitute their wisdom for the statutory language. *Id.*

The Eighth Circuit again strayed from the statutory language in interpreting the "actual damages" provision of section 28(a). The term "actual damages" appears only in the context of authorizing parallel state and fed-

eral remedies. It was designed only to prevent duplicative recoveries based on state and federal law. *E.g., Osofsky v. Zipf,* 645 F.2d 107, 111 (2d Cir. 1981).

II. The rule of *Hanover Shoe, Inc., v. United Shoe Mach. Corp.,* 392 U.S. 481, 503 (1968) and of *Norfolk & W. Ry. v. Liepelt,* 444 U.S. 490, 493-94 (1980) that taxes are to be taken into account in calculating the amount of recovery only when the recovery is tax-free remains sound. An investor in a "tax shelter" defers the payment of taxes. When the "tax shelter" is concluded, the investor must pay the taxes which he deferred. Because of changes in the investor's other income, changes in the Internal Revenue Code and variations in applicable marginal rates, the amount of taxes the investor actually pays in a later year may be greater or less than the amount would have been at the time the taxes would have been due but for the "tax shelter." The "rough result of not taking account of taxes for the year of injury but then taxing recovery" is "the most satisfactory outcome." *Hanover Shoe, Inc. v. United Shoe Mach. Corp.,* 392 U.S. at 503.

III. The purpose of the Securities Act of 1933

> is to protect the investing public and honest business. . . . The aim is to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation; to place adequate and true information before the investor; to protect honest enterprise, seeking capital by honest presentation, against the competition afforded by dishonest securities offered to the public through crooked promotion . . . .

S. Rep. No. 47, 73d Cong., 1st Sess. 1 (1933), *reprinted in* 2 J. Ellenberger & E. Mahar, Legislative History of the Securities Act of 1933 & the Securities Exchange Act of 1934 (1973); *see also United States v. Naftalin,* 441 U.S. 768, 775 (1979); *SEC v. Capital Gains Research Bur-*

eau, Inc., 375 U.S. 180, 186-87 (1963). There is "no warrant for narrowing" the safeguards created by Congress. *See United States v. Gilliland*, 312 U.S. 86, 93 (1941).

The Eighth Circuit saw the function of section 12(2), section 10(b) and Rule 10b-5 only as one of compensating defrauded investors "for any actual monetary loss." Even if it were true that an award of $506 as of December 15, 1983, fully compensated an investor's actual monetary loss which had resulted from investing $35,000 in a worthless security on November 13, 1973, the award would not accomplish the statute's purpose in deterring fraud.

Fraud can be deterred only if investors have sufficient incentives to seek a recovery and thus to compel promoters to pay damages in amounts large enough to induce full disclosure. F. Easterbrook & D. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611, 620 (1985). The threat of civil liability is an important mechanism for coercing adequate disclosure. Only if the sanction of civil liability is sufficiently serious (and the damages sufficiently high) will fraud be deterred and accurate and complete information be provided to prospective investors. Note, *Real Estate Limited Partnerships & Allocational Efficiency: The Incentive to Sue for Securities Fraud*, 63 VA. L. REV. 669, 685 (1977).

ARGUMENT

I. THE INTERPRETATION OF SECTION 12(2) AND THE CALCULATION OF DAMAGES UNDER SECTION 10(b) AND RULE 10b-5 MUST BE CONSISTENT WITH THE LANGUAGE OF THE STATUTES AND THE RULE.

"The starting point" for the interpretation of the federal securities laws "is the language [of the statute]

itself." *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. at 756 (concurring opinion); *accord, Landreth Timber Co. v. Landreth*, 105 S. Ct. at 2301; *Teamsters v. Daniels*, 439 U.S. at 558; *Ernst & Ernst v. Hochfelder*, 425 U.S. at 197. In attempting to interpret section 12(2) and to define the damages which section 28(a) permits to be recovered under section 10(b) and Rule 10b-5, the Eighth Circuit started at the wrong point. It disregarded the clear language and effectively rewrote the statutes under the guise of interpreting them.

When a court sets out to interpret a statute, it is to determine "only what the statute means." O. Holmes, *The Theory of Legal Interpretation*, 12 HARV. L. REV. 417, 419 (1898); *see also S & E Contractors, Inc. v. United States*, 406 U.S. 1, 14 n.9 (1972). If the language of a statute is plain, it is the duty of a court to enforce the statute as written. *United States v. Standard Brewery, Inc.*, 251 U.S. 210, 217 (1920). Absent a clearly expressed legislative intent to the contrary, the language of a statute must ordinarily be regarded as conclusive. *Consumer Prod. Safety Comm'n v. GTE Sylvania, Inc.*, 447 U.S. 102, 108 (1980). "In construing a federal statute it is appropriate to assume that the ordinary meaning of the language that Congress employed 'accurately expresses the legislative purpose.'" *Mills Music, Inc. v. Snyder*, 105 S. Ct. 638, 645 (1985).

A. There Is No Statutory Basis For Differentiating Between "Tax Shelters" And Other Securities.

Section 12(2) applies to all fraudulent sales of "a security" and provides the same remedy to all defrauded purchasers. Section 10(b) and Rule 10b-5 apply to "the purchase or sale of any security." Section 28(a) applies

to all suits for damages under section 10(b) and Rule 10b-5. Section 12(2), sections 10(b) and 28(a) and Rule 10b-5 say nothing about a special rule for suits seeking recovery on account of frauds related to "tax shelters."

The Eighth Circuit held that

> in a private securities fraud action involving an investment structured and marketed as a tax shelter, where a rescissory measure of damages is applied, evidence of any benefit derived by the plaintiff/investor via tax savings must be permitted.

Austin I at 183-84. The Eighth Circuit expressly restricted its holding "to cases involving investments that are expressly marketed and sold as tax shelters."[9] *Austin I* at 183; *accord, Austin II* at 954 (holding applies only to "special case of tax shelter investments").

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[9] Alotel Associates does not meet the definition of a "tax shelter" established by the Internal Revenue Code. *See* 26 U.S.C. § 6111(c)(1) ("tax shelter" means an investment represented as providing a "tax shelter ratio" for an investor "greater than 2 to 1" during any of first 5 years). The Offering Memorandum projected investment, deductions and credits as follows:

Year	*Investment*	*Deductions*	*Credits*
1973	$35,000	$20,395	$2,432
1974		14,695	
1975		2,960	
1976		476	
1977		(1,929)	

(Pl.Ex.2 at 27; Tr.42). Thus, the "tax shelter ratio" during the first 5 years was to be

Year	*Ratio*
1973	.72/1
1974	1.14/1
1975	1.23/1
1976	1.24/1
1977	1.18/1

See 26 U.S.C. § 6111(c)(2). Because the ratio was never represented as reaching 2 to 1, an investment in Alotel Associates could not be characterized as a "tax shelter."

That holding creates a distinction with no statutory basis. If there were to be a rule that "income" under section 12(2) includes "tax benefits" and that damages under section 10(b) and Rule 10b-5 must be reduced by "tax benefits," the rule should apply to all cases. There is no basis for distinguishing a fraudulent sale of a security "structured and marketed as a tax shelter" from a fraudulent sale of a security not so structured and marketed. Common stock, if it becomes worthless, generates a "tax benefit" for the investor. Yet, if the investor had purchased the stock in reliance on a misrepresentation and if the stock had become worthless, the Eighth Circuit would not reduce his recovery on account of the "tax benefits" he had obtained.[10]

The Eighth Circuit justified its distinction on the ground that the "tax benefits" were "bargained for." *Austin II* at 955. That justification ignores the obvious: every purchase of a security includes a "bargain" concerning the tax consequences. Every purchaser knows of and accepts the holding period for capital gains treatment, the deduction available if the security becomes worthless

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[10] An investor receives "tax benefits" in a variety of circumstances involving purchases of securities. He is permitted to take a loss when a security, *i.e.*, stock, bond, debenture or note, becomes worthless. *See* 26 U.S.C. § 165(g). He is permitted to reduce his taxable income on account of contributions to an individual retirement account, *see* 26 U.S.C. § 219, on account of a qualified reinvested stock dividend, *see* 26 U.S.C. § 305(b), on account of a contribution by a self-employed person to a pension or profit-sharing plan, *see* 26 U.S.C. § 401(c), and on account of a qualified cash arrangement by which he directed an employer to contribute to a qualified trust. *See* 26 U.S.C. § 401(k). He is permitted to elect to have a tax-exempt organization which employs him reduce his income and use the monies to purchase an annuity for him. *See* 26 U.S.C. § 403(b). Such deductions defer taxes in the same manner as does a "tax shelter" and thus create "tax benefits."

or is sold at a loss, etc. The purchase of a "tax shelter" differs only in the specifics of the "tax benefits" that were bargained for.

B. The Language Of Section 12(2) Does Not Allow Deduction Of "Tax Benefits" From A Defrauded Purchaser's Recovery.

Section 12(2)'s language is straightforward. The statute allows a defrauded purchaser

> to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security. . . .

The measure of recovery for a defrauded purchaser who still owns the security has three elements: (1) the consideration paid, (2) interest on the consideration and (3) income received.

1. "Tax Benefits" Are Not "Income."

The district court attempted to use "the ordinary meaning" of the term "income" in interpreting section 12(2). *Cf. Mills Music, Inc. v. Snyder,* 105 S. Ct. at 645. The district court found that there had been a timely tender of the limited partnership units, concluded that rescission was appropriate and refused to reduce the recovery under section 12(2) on account of "tax benefits." (Pet.App.D10,D17,E15-E16).

The Eighth Circuit rejected the district court's literal reading of section 12(2). Although it acknowledged that tax benefits received were not a form of income in a strict accounting sense, *Austin II* at 955, the Eighth Circuit nevertheless held that

> section 12(2)'s language "income *received* thereon" may properly be construed as including tax benefits bargained for and received . . . .

Austin II at 958 (emphasis in original).

The Eighth Circuit disregarded "the ordinary meaning" of the word "income."[11] "Income" normally means "gain derived from capital, from labor, or from both combined." *Eisner v. Macomber,* 252 U.S. 189, 207 (1920). "Tax benefits" are not gain derived from capital or labor.

In interpreting a term, courts are to use a "well-settled meaning" if one exists. *See Landreth Timber Co. v. Landreth,* 105 S. Ct. at 2302. "Income" carries a "well-settled meaning." 26 U.S.C. § 61 establishes the meaning of "income":

> compensation for services, . . . gross income derived from business, gains derived from dealings in property, interest, rents, royalties, dividends, . . . income from discharge of indebtedness [and] distributive share of partnership gross income.

"Tax benefits" are not included within that "well-settled meaning" of "income."[12]

Courts also look to "significant characteristics typically associated with" terms in attempting to interpret them. *See Landreth Timber Co. v. Landreth,* 105 S. Ct. at 2302; *United Housing Foundation, Inc. v. Forman,* 421 U.S. at 851. "Income" has "significant characteristics." One of those characteristics is taxability. "Tax benefits," of course, are not taxable. If deductions were "income," every taxpayer who took a deduction in one year would be required to include it within "gross income" on the fol-

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11 One commentator noted that *"Austin [I]* is without precedent in classifving tax benefits received by the plaintiff as 'income' within the meaning of section 12(2)." Note, *Austin v. Loftsgaarden: Securities Fraud in Real Estate Limited Partnership Investments,* 16 CREIGHTON L. REV. 1140, 1151 (1982).

12 Although "income" expressly includes a "distributive share of partnership gross income," 26 U.S.C. § 61(a)(1), it does not include "tax benefits" attributable to a distributive share of partnership losses.

lowing year's tax return. *Austin II* at 963 n.1 (dissenting opinion). No reported case or revenue ruling construes a deduction or credit as "income."[13] *See* 26 U.S.C. § 61.

In *United Housing Foundation, Inc. v. Forman,* 421 U.S. 837, this Court considered whether non-interest bearing shares in a non-profit housing cooperative were "investment contracts" and therefore "securities," as that term is used in section 2(1) of the Securities Act of 1933. An "investment contract" requires an "expectation of profits." The sellers therefore argued that the purchasers had bought the shares to obtain housing, not to obtain income or profits. The court of appeals disagreed, holding that profit might "be derived from the income yielded by an investment," *id.* at 855, and that one source of such income was "tax deductions for the portion of the monthly rental charges allocable to interest payments on the mortgage." *Id.* at 846.

This Court reversed, stating that the conclusion that tax deductions are a "supposed source of income or profits may be disposed of summarily." *Id.* at 855. It held that income or profits means "either capital appreciation resulting from development of the initial investment . . . or a participation in earnings resulting from the use of the investors' funds," *id.* at 852, and concluded:

> We know of no basis in law for the view that the payment of interest, with its consequent deductibility for tax purposes, constitutes income or profits.

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[13] Respondents themselves did not argue that tax benefits constituted income. *Austin II* at 958 ("Loftsgaarden argues that . . . tax benefits are a return of 'consideration paid' "). Respondents' own expert also testified that "tax benefits" were not "income." (R.178). The district court took "judicial notice that [Randall] didn't receive any income." (R.179).

Id. at 855. If "tax benefits" do not constitute income or profits under section 2(1), then "tax benefits" should not be considered income under section 12(2).[14]

"Income," as used in section 12(2), does not include every favorable economic consequence. In *Johns Hopkins Univ. v. Hutton,* 297 F. Supp. at 1232, payments made by the seller to defrauded purchasers intended to be applied to taxes were held not to be "income" under section 12(2). *See also* M. Kaminsky, *An Analysis of Securities Litigation under Section 12(2),* 13 Hous. L. Rev. 231, 281 (1976); 5C A. Jacobs, Litigation & Practice Under Rule 10b-5 § 260.03[c][vi] at 11-56 n.3 (2d ed. 1985); 26 U.S.C. § 61.

The Eighth Circuit rationalized that its expansive interpretation of "income" reflected "economic reality" and that to ignore "tax benefits actually realized . . . would be unrealistic." *Austin II* at 955 & n.9. That rationalization flies in the face of a cardinal principle of rescission: "[t]he goal of rescission under section 12(2) is to return the parties to the status quo ante." *Austin II* at 954. The Eighth Circuit purports to return Petitioners to the status quo ante, but it never purports to return Respondents to the status quo ante or to require them to disgorge their unlawfully obtained profits. As the dissent noted:

> There was evidence at trial showing Loftsgaarden received over $100,000 profit from the investment scheme. Under the majority's approach, Loftsgaarden

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[14] The Eighth Circuit tried to distinguish *United Housing Foundation* by characterizing the tax benefits at issue there as "marginal" and those now at issue as "the primary motivation behind the investment." *Austin II* at 955. Such a distinction should be of no consequence. Nothing in section 12(2) contemplates substracting substantial "tax benefits" from damages but ignoring marginal ones.

> gains both his own profit from the scheme and the advantage of plaintiffs' speculative tax benefits.[15]

Austin II at 963 (dissenting opinion).

The Eighth Circuit's rationalization also assumes that "tax benefits" would provide a "windfall" to defrauded purchasers unless those "tax benefits" were deducted from their recoveries. The Eighth Circuit therefore chose to award the "windfall" to defrauding sellers. Even if a defrauded purchaser were to obtain a windfall, it would be "more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them."[16] *Myzel v. Fields*, 386 F.2d 718, 747 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); *Janigan v. Taylor*, 344 F. 2d 781, 786 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965); *see also Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1305 (2d Cir. 1973); *Johns Hopkins Univ. v. Hutton*, 297 F. Supp. at 1226.

The Eighth Circuit's rationalization also ignores the legislative history. That history demonstrates that a defrauded purchaser is to obtain his recovery from the seller. H.R. Rep. No. 85, 73d Cong., 1st Sess. 9 (1933), *reprinted in* 2 J. Ellenberger & E. Mahar, Legislative History of the Securities Act of 1933 & the Securities Exchange Act of 1934 (1973) (defrauded purchaser can "sue for recovery of his purchase price"); S. Rep. No. 47, 73d Cong. 1st Sess.

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15 The evidence showed that PDRC received no less than $80,490, that 2361 received no less than $213,334 and that arc-TECH, inc., received $90,000.

16 Petitioners will get no windfall. Any recoveries will be subject to tax. Furthermore, it would be

> reasonable to assume that if plaintiffs had not invested in Loftsgaarden's fraudulent scheme, they would have invested in another legitimate project which would have returned similar tax benefits as well as principal and interest over the life of the investment. . . .

Austin II at 964 n.2 (dissenting opinion).

6 (1933), *reprinted in* 2 J. Ellenberger & E. Mahar, LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 & THE SECURITIES EXCHANGE ACT OF 1934 (1973) (defrauded purchaser can "sue for a return of his money"); 77 Cong. Rec. 2913 (1933) (defrauded purchaser can get his "money back" from seller).

2. "Interest" Should Not Be Added To "Tax Benefits" Even If "Tax Benefits" Were To Be Considered "Income Received."

The Eighth Circuit compounded its error by subtracting interest on the "tax benefits" from the "consideration paid." *Austin II* at 959. That further reduces a defrauded purchaser's recovery under section 12(2). After remand, the district court had stated:

> The clear language of [section] 12(2) presents the order in which to consider these items: "consideration paid . . . with interest thereon, less the amount of any income received . . . ." These words present an express directive to this court, and [the] defendant[s] cite no cases directly on point which hold to the contrary.

(Pet.App.C7). The Eighth Circuit reversed. It conceded that the result of its holding as to section 12(2) was to permit a defrauded purchaser "to recover the amount paid for [the security] with interest, less the amount received with interest." *Austin II* at 959, *quoting Murphy v. Cady*, 30 F. Supp. 466, 470 (D. Me. 1939), *aff'd* 113 F.2d 988 (1st Cir.), *cert. denied*, 311 U.S. 705 (1940).

Section 12(2) mandates recovery of "the consideration paid for the security with interest thereon, less the amount of any income received thereon." The Eighth Circuit effectively rewrote the latter portion of the statute to read "less the amount of any income received thereon

with interest thereon." The words "interest thereon" modify only "consideration paid." The word "thereon" has no other antecedent. Interest is to be added only to the "consideration paid," and "income received" is then to be subtracted from the sum. *See Johns Hopkins Univ. v. Hutton*, 297 F. Supp. at 1231 [adding interest to "income received" under section 12(2) would be proper only if court had "power, to in effect, rewrite the remedial language of the statute"].

C. Nothing In Section 28(a) Justifies Reducing Damages Under Section 10(b) And Rule 10b-5 By "Tax Benefits."

Damages under section 10(b) and Rule 10b-5 are limited by section 28(a). Section 28(a) provides:

> The rights and remedies provided by [the Securities Exchange Act of 1934] shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of [the Securities Exchange Act of 1934] shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of . . . .

The Eighth Circuit concluded that "a plaintiff can recover no more than his 'net economic loss' " and held that "net economic loss" was to be equated with "actual damages." *Austin II* at 954; *accord, Salcer v. Envicon Equities Corp.*, 744 F.2d 935, 940 (2d Cir. 1984), *petition for cert. filed*, 53 U.S.L.W. 3688 (U.S. Mar. 13, 1985) (No. 84-1447).

That interpretation begs the question of what is intended by the term "actual damages." A careful examination of section 28(a) and of other statutes that use the term and a review of judicial construction of the term demonstrate that "actual damages" does not require a reduction of damages on account of "tax benefits."

First, the sentence structure of section 28(a) suggests that Congress meant only to prevent duplicative recoveries when a plaintiff asserted a state law claim as well as a federal securities law claim. The first clause of section 28(a) provides that federal remedies do not preempt state remedies. The phrase "actual damages" prevents a plaintiff from recovering more than once if he pursues both federal and state causes of action.[17] *E.g., Osofsky v. Zipf*, 645 F.2d at 111.

Second, although Congress did not define the term "actual damages" when it enacted section 28(a), the term already had an accepted meaning. The term was used in statutes governing patent, copyright and trademark infringement. *See* 35 U.S.C. § 67 (1928); 17 U.S.C. § 25 (1928); 15 U.S.C. §§ 16-19 (1928).

This Court had defined the term "actual damages," as used in the patent statutes, to require damages to be "given as a compensation, recompense, or satisfaction to the plaintiff, for an injury actually received." *Birdsall v. Coolidge*, 93 U.S. 64 (1876). The copyright and trademark statutes allowed a plaintiff to recover both his "injury" and the infringer's "profits" and equated "injury" and "profits" with "actual damages." *See* 17 U.S.C. § 25 (1928); 15 U.S.C. § 19 (1928).

In *L. P. Larson, Jr., Co. v. William Wrigley, Jr., Co.*, 277 U.S. 97 (1928), this Court refused to deduct income taxes from a recovery for trademark infringement. This Court held:

> To review one of these questions a writ of certiorari was granted by this court. That question is whether

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[17] A strict construction of section 28(a), which refers only to "a suit for damages," may preclude any limitation on the equitable remedy of rescission. *See* Note, *Insiders Liability under Rule 10b-5 for the Purchase of Actively Traded Securities*, 78 YALE L.J. 864, 874 n.51 (1969).

> . . . the Wrigley Company should be allowed to deduct the Federal income and excess profits taxes from the profits with which it is to be charged.
>
> * * *
>
> Even if the only relief that the Wrigley Company can get is a deduction from gross income when the amount of its liability is finally determined, the Larson Company will have to pay a tax on the Wrigley profits when it receives them, and in a case of what has been found to have been one of conscious and deliberate wrongdoing, we think it just that the further deduction should not be allowed.

Id. at 99-100. Thus, when the Securities Exchange Act of 1934 became law, the term "actual damages" did not require damages to be reduced because of tax consequences.[18]

The reasoning behind the judicial refusal to credit an infringer with the taxes paid on the profits being recovered in patent, copyright and trademark cases applies equally to securities fraud cases. Recovery for patent, copyright or trademark infringement is not reduced by

> income taxes . . . since plaintiffs will be required to pay income taxes on any amount recovered and should not have that amount diminished . . . .

Carter Prod., Inc. v. Colgate-Palmolive Co., 214 F. Supp. 383, 406 (D. Md. 1963). Recoveries in securities fraud cases are also taxable and also should not be diminished.

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[18] Subsequent patent, copyright and trademark cases continued to apply the rule and refused to consider tax consequences when computing damages. *See, e.g., Wolf v. National Lead Co.*, 272 F.2d 867, 873 (9th Cir. 1969) (income taxes paid by infringer are not a proper deduction when accounting for a trademark infringer's profit); *Alfred Bell & Co. v. Catalda Fine Arts, Inc.*, 191 F.2d 99, 106 (2d Cir. 1951) (error to allow deduction when accounting for a copyright infringer's profits); *Sheldon v. Metro-Goldwyn Pictures Corp.*, 106 F.2d 45, 53 (2d Cir. 1939), *aff'd*, 309 U.S. 390 (1940); *Goodyear Tire & Rubber Co. v. Overman Cushion Tire Co.*, 95 F.2d 978, 985 (6th Cir. 1937) (no deduction from profits for income taxes paid by patent infringer).

Third, deducting tax benefits from damages gives a defrauder the benefit of provisions of the Internal Revenue Code that were structured to benefit investors. The Eighth Circuit expressed concern that, if Respondents were to retain the "tax benefits," Respondents would reap a windfall, *i.e.*, something in excess of their "actual damages." This Court has not seen fit to interpret "actual damages" to restrict recoveries in any such way. In *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), defrauded sellers sought to recover profits earned by the defrauder. The defrauder objected that such a recovery was precluded by the "actual damages" limitation of section 28(a). This Court held that the "actual damages" limitation does not prevent recoveries constituting "more than the [defrauded] seller's actual loss" in actions under section 10(b). *Id.* at 155.

Thus the "actual damages" limitation does not prevent a plaintiff from recovering a "windfall," *Myzel v. Fields*, 386 F.2d at 747; *Janigan v. Taylor*, 344 F.2d at 786, nor does it prevent a plaintiff from recovering more than his "actual loss." *Affiliated Ute Citizens v. United States*, 406 U.S. at 155. Neither should the limitation prevent a plaintiff from recovering damages in reduction by "tax benefits."

II. PERMITTING DEFRAUDED PURCHASERS TO RECOVER THEIR "CONSIDERATION PAID . . . WITH INTEREST" WITHOUT A REDUCTION FOR "TAX BENEFITS" IS CONSISTENT WITH PRECEDENT.

A. The Eighth Circuit's Decision Fails To Defer To This Court's Precedent.

The Eighth Circuit's decision that recoveries for securities fraud must be reduced by "tax benefits" cannot be reconciled with this Court's decisions. The impact of

taxes on recovery is the subject of a number of significant opinions.

In *Hanover Shoe, Inc. v. United Shoe Mach. Corp.*, 392 U.S. 481, this Court first addressed a party's argument that an adversary's damages must be reduced to the "after-tax profits that [the adversary] failed to receive." *Id.* at 503. This Court held that

> to diminish the actual damages by the amount of taxes that [a plaintiff] would have paid had it received greater profits in the years it was damaged would be to apply a double deduction for taxation, leaving [the plaintiff] with less income than it would have had if [the defendant] had not injured it.

Id. This Court, recognizing the changing rates of taxation, expired statutes of limitation and difficulties in recomputing taxes that would have accrued over a period of years, stated that

> the rough result of not taking account of taxes for the year of injury but then taxing recovery when received seems the most satisfactory outcome,

id., and held that damages should equal pre-tax profits and that the IRS should be permitted to tax the recovery. *Id.*

In *Norfolk & W. Ry. v. Liepelt*, 44 U.S. 490, this Court held that it was necessary to instruct a jury that a damage award would not be taxable. *Id.* at 491. This Court recognized that an injured individual's after-tax income, not his gross income before taxes, was the relevant factor in calculating the damages sustained by his dependents when he died. *Id.* at 493-94. This Court again recognized the complexities in predicting the many variables; nevertheless, it held that the danger of overcompensation based on an erroneous assumption concerning taxability required the admission of expert testimony concerning income tax

liability for future wages and the giving of an instruction that a judgment would not be taxable. *Id.* at 497-98.

In *Jones & Laughlin Steel Corp. v. Pfeifer,* 462 U.S. 523 (1983), this Court offered guidance to those seeking to reconcile *Hanover Shoe* with *Liepelt.* This Court stated that, when the damages award itself is to be tax-free, the evidence to be considered is that concerning "after-tax" amounts. It implied that, when the damage award itself is taxable, evidence of taxes paid or to be paid should be excluded. *Id.* at 547-51.

The Eighth Circuit applied *Liepelt* to Petitioners' claims for damages even though it recognized that each would "have to pay taxes on his award." The Eighth Circuit failed to consider *Hanover Shoe* or *Pfeiffer.* In doing so, the Eighth Circuit glossed over *Liepelt's* predicate that its holding applied only when an award of damages is not taxable.

B. The Eighth Circuit's Decision Fails To Defer To Other Precedent.

Courts interpreted the federal securities laws and provided remedies to defrauded purchasers for over thirty years before the deductibility of tax benefits surfaced as an issue in a reported decision. *See Cooper v. Hallgarten & Co.,* 34 F.R.D. 482 (S.D.N.Y. 1964). When defendants first argued that a plaintiff's recovery should be reduced by an amount equal to the tax benefits flowing from an investment, court uniformly rejected those arguments. *See, e.g., Rhode v. Hershberger Explorations, Inc.,* 349 F. Supp. 993, 994 (D. Minn. 1972); *Johns Hopkins Univ. v. Hutton,* 297 F. Supp. at 1232; *Wiesenberger v. W. E. Hutton & Co.,* 35 F.R.D. 556, 557 (S.D.N.Y. 1964); *Cooper v. Hallgarten & Co.,* 34 FR.D. at 484; *see also Chris-Craft Indus., Inc., v. Piper Aircraft Corp.,* 480 F.2d 341, 391

(2d Cir.), *cert. denied,* 414 U.S. 910 (1973) ("party seeking rescission must return any proceeds . . . received from the transaction being rescinded [but] the proceeds that must be returned are [only] those received from the other party").

Some courts eventually permitted discovery concerning "tax benefits" because information discovered might be relevant to issues other than damages. Courts which permitted such discovery considered it relevant to valuation of the investment, *see Dupuy v. Dupuy,* 551 F.2d 1005, 1025 (5th Cir.), *cert. denied,* 434 U.S. 911 (1977); *Smith v. Bader,* 83 F.R.D. 437, 439 (S.D.N.Y. 1979); *cf. Berg v. Xerxes-Southdale Office Bldg. Co.,* 290 N.W.2d 612, 615 (Minn. 1980), to misrepresentation of tax benefits, *Bridgen v. Scott,* 456 F. Supp. 1048, 1062 (S.D. Tex. 1978); *Bayoud v. Ballard,* 404 F. Supp. 417, 426 (N.D. Tex. 1975), to causation, *see Houlihan v. Anderson-Stokes, Inc.,* 78 F.R.D. 232, 234 (D.D.C. 1978), to reliance, *see Smith v. Bader,* 83 F.R.D. at 439; *Sharp v. Coopers & Lybrand,* 83 F.R.D. 343, 352 (E.D. Pa. 1979), *rev'd on other grounds,* 649 F.2d 175 (3d Cir. 1981), *cert. denied,* 455 U.S. 938 (1982), and to laches. *See Hickman v. Groesbeck,* 389 F. Supp. 769, 780 (D. Utah 1974). Other courts continued to consider tax benefits wholly irrelevant. *E.g., Spatz v. Borenstein,* 513 F. Supp. 571, 576-86 (N.D. Ill. 1981); *see also Borovoy v. Bursar Realty Corp.,* 86 Mich. App. 732, 738, 273 N.W.2d 545, 548 (1979) (tax consequences "do not enter into the computation of damages" under Michigan's securties laws); *G & R Corp. v. American Sec. & Trust Co.,* 523 F.2d 1164, 1173-74 (D.C. Cir. 1975) (contract damages not to be offset by tax benefits).

The Eighth Circuit was the first to require that a recovery be reduced by tax benefits. *Austin I* at 183; Note, *Austin v. Loftsgaarden: Securities Fraud in Real Estate*

Limited Partnership Investments, 16 CREIGHTON L. REV. at 1151. Most other courts rejected the Eighth Circuit's approach. *E.g., Western Fed. Corp. v. Erickson*, 739 F.2d 1439, 1444 (9th Cir. 1984); *Burgess v. Premier Corp.*, 727 F.2d 826, 837-38 (9th Cir. 1984); *Koehler v. Pulvers*, [Current] FED. SEC. L. REP. (CCH) ¶ 92,232 at 91,671 (S.D. Cal. 1985); *Hokama v. E. F. Hutton & Co.*, 566 F. Supp. 636, 847-48 (C.D. Cal. 1983); *see also Eisenberg v. Gagnon*, 766 F.2d 770, 782 (3d Cir. 1985) (deductibility of losses not to be considered in assessing damages); *Danzig v. Jack Grynberg & Assoc.*, 161 Cal. App. 3d 1128, 1139-40, 208 Cal. Rptr. 336, 343-44 (1984), *cert. denied*, 106 S. Ct. 67 (1985) (limited partners' tax consequences irrelevant to their rescissionary recovery based upon misrepresentation); *Harris v. Metropolitan Mall*, 112 Wis. 2d 487, 501-02, 334 N.W.2d 519, 526 & n.21 (1983) (tax consequences of "tax shelter" do not reduce restitutionary recovery). The Second Circuit, however, adopted the Eighth Circuit's approach. *See Freschi v. Grand Coal Venture*, 767 F.2d 1041, 1050-51 (2d Cir. 1985), *petition for cert. filed*, 54 U.S.L.W. 3154 (U.S. Sept. 6, 1985) (No. 85-377); *Salcer v. Envicon Equities Corp.*, 744 F.2d at 940-44.

C. Deducting "Tax Benefits" From Recoveries For Securities Fraud Disregards The Collateral Source Rule.

The Eighth Circuit's decision vitiates the "collateral source" rule. The rule is set forth in RESTATEMENT (SECOND) OF TORTS § 920A(2) (1979):

> Payments made to or benefits conferred on [an] injured party from other sources are not credited against the tortfeasor's liability, although they cover all or a part of the harm for which the tortfeasor is liable.

The rule means that

> a benefit that is directed to the injured party should not be shifted so as to become a windfall for the tortfeasor. If the plaintiff was himself responsible for the benefit, as by maintaining his own insurance or by making advantageous employment arrangements, the law allows him to keep it for himself. If the benefit was a gift to the plaintiff from a third party or established for him by law, he should not be deprived of the advantage that it confers. The law does not differentiate between the nature of the benefits, so long as they did not come from the defendant or a person acting for him.

Id. comment b.

The Eighth Circuit held that

> the tax benefits of plaintiffs' investments are not a collateral source because "although paid by the government, [they] emanate directly from the tax shelter sought by the plaintiffs and provided by defendants, without which plaintiffs could not have realized any tax benefits. Benefits resulting directly from a transaction under attack must be credited toward the damage award.

Austin II at 956, *quoting Salcer v. Envicon Equities Corp.*, 744 F.2d at 941-42. That analysis misconstrues the nature of a "collateral source."[19]

Every collateral source results "directly" from the tort or transaction at issue; otherwise, no defendant could claim to reduce his obligation based on a payment from the "collateral source." Health and disability insurance payments come from a "collateral source" and do not re-

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[19] The analysis fails to acknowledge that there would be no "tax benefits" but for a defrauded purchaser's income from other sources.

duce the damage for which the tortfeasor is liable even though the injury and hence the insurance payments result "directly" from the tort. The rule applies even if the tortfeasor contributes to a fund which provides the benefits. *E.g., Eichel v. New York Cent. R.R.*, 375 U.S. 253, 254-55 (1963); *NLRB v. Gullett Gin Co.*, 340 U.S. 361, 364 (1951); *Kauffman v. Sidereal Corp.*, 695 F.2d 343, 346-47 (9th Cir. 1982).

The proper question is whether the benefit is conferred on an injured party from a source other than the defendant. RESTATEMENT (SECOND) OF TORTS § 920A(2). Petitioners' "tax benefits" come from a third party, *i.e.*, the government, and are calculated based on Petitioners' other income. R. Thompson, *The Measure of Recovery under Rule 10b-5*, 37 VAND. L. REV. 349, 390 (1984) ("plaintiff who receives a tax benefit obtains his advantage from the government, not from the defendant"). Petitioners' "tax benefits" do not come from Respondents. Because the "tax benefits" were established for [them] by law," Petitioners "should not be deprived of the advantage" created. *See* RESTATEMENT (SECOND) OF TORTS § 920A(2) comment b; *Funston v. United States*, 513 F. Supp. 1000, 1010 (M.D. Pa. 1981) ("tax benefit conferred by [the state] is from a collateral source"); *Iowa-Des Moines Nat'l Bank v. Schwerman Trucking Co.*, 288 N.W.2d 198, 205 (Iowa 1980) ("tax saving [is to be] treated as a collateral source"); *Cereal Byproducts Co. v. Hall*, 16 Ill. App. 2d 79, 81, 147 N.E.2d 383, 384, *aff'd*, 15 Ill. 2d 313, 155 N.E.2d 14 (1958) (tax consequences of theft loss treated as being from collateral source); *Lumber Terminals, Inc. v. Nowakowski*, 36 Md. App. 82, 97, 373 A.2d 2[illegible], 291-92 (1977) ("[t]axes are strictly between plaintiff as taxpayer and

the government as collector, and are of no legitimate concern of the defendants'').

III. PUBLIC POLICY CONSIDERATIONS REQUIRE THAT "TAX BENEFITS" NOT BE SUBTRACTED FROM SECURITIES FRAUD RECOVERIES.

This Court often considers practical factors and considerations of policy in explicating congressional intent. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. at 749. All practical and policy considerations require courts to disregard "tax benefits" in calculating recoveries under the federal securities laws.

A. Subtracting "Tax Benefits" From Securities Fraud Recoveries Undermines The Disclosure Requirements Of The Federal Securities Laws.

In 1933 President Roosevelt appealed to Congress in seeking passage of the Securities Act of 1933:

> This proposal adds to the ancient rule of caveat emptor, the further doctrine, "Let the seller also beware." It puts the burden of telling the whole truth on the seller. *It should also give impetus to honest dealing in securities* . . . .

77 Cong. Rec. 937 (1933) (emphasis added). The preamble to the Securities Act states that its purpose is to

> provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and *to prevent frauds* in the sale thereof . . . .

47 Stat. 74 (1933) (emphasis added). When it became law, the Securities Act of 1933 created "a system of full disclosure." T. Hazen, THE LAW OF SECURITIES REGULATION

§ 1.2 at 7 (1985); *see also* 1 L. Loss, SECURITIES REGULATION 184 (2d ed. 1961). The Securities Exchange Act of 1934 is intended to regulate all aspects of the public trading of securities, bars material misstatements and omissions and requires full disclosure. T. Hazen, THE LAW OF SECURITIES REGULATION § 1.2 at 7; *see also* 1 L. Loss, SECURITIES REGULATION 184.

The Securities Act of 1933 and the Securities Exchange Act of 1934 implement the requirement of full disclosure by five primary means: (1) SEC examination of registration documents to determine compliance with the laws' disclosure requirements, (2) SEC initiation of injunction proceedings, (3) SEC administrative hearings and sanction procedures, (4) criminal prosecutions and (5) private litigants' suits for restitution and damages. T. Hazen, THE LAW OF SECURITIES REGULATION § 1.3 at 10-11; 1 L. Loss, SECURITIES REGULATION 302-03; 2 L. Loss, SECURITIES REGULATION 845-57 (2d ed. 1961); T. Hazen *Administrative Enforcement: An Evaluation of the SEC's Use of Injunctions & Other Enforcement Methods,* 31 HASTINGS L.J. 427 (1979); S. REP. No. 47, 73d Cong., 1st Sess. 6 (1933), *reprinted in* 2 J. Ellenberger & E. Mahar, LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 & THE SECURITIES EXCHANGE ACT OF 1934 (1973); *see also United States v. Naftalin,* 441 U.S. at 778; *Red Bank Oil Co.,* 20 S.E.C. 863, 866 (1945).

The Securities Act of 1933 exempts certain securities from its registration requirements because of the "small amount involved" or because of the limited character of

the public offering, 15 U.S.C. § 77c, and exempts certain transactions because of the nature of the transactions or the participants. 15 U.S.C. § 77d. Most limited partnership offerings[20] fall within one or more exemptions.[21] Therefore, the SEC has no opportunity to examine documents prior to sale. Because neither the SEC nor the Department of Justice has the resources to police all of the fraudulent activity by organizers of limited partnerships,[22] the primary tool in enforcing the disclosure requirements is the private civil action. Note, *Real Estate Limited Partnerships & Allocational Efficiency: The Incentive to Sue for Securities Fraud,* 63 VA. L. REV. at 670-71.

The incentive to make full disclosure thus is in direct relation to the likelihood and risk of a successful suit. *Id.* at 671; *see also* F. Easterbrook & D. Fischel, *Optimal Damages in Securities Cases,* 52 U. CHI. L. REV. at 614-30. The Eighth Circuit's decision makes it unlikely that

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20 The total invested in limited partnerships in 1983 was estimated to be $8.4 billion. TIME, Nov. 26, 1984 at 26. The total invested in 1984 was estimated to be $19 billion. 4 R. Haft & P. Fass, TAX SHELTERED INVESTMENTS vii (3d ed. 1985). In 1980 there were approximately 211,000 real estate limited partnerships in existence. Bureau of Nat'l Affairs, Inc., *Daily Report for Executives* (Feb. 21, 1984).

21 In a 12 month period during 1975-1976 only 10 limited partnerships were registered with the SEC. [1976] 5 FED. SEC. L. REP. (CCH) at 64,214. In a similar period during 1984-1985 less than 60 real estate limited partnerships were registered. [1985] 6 FED. SEC. L. REP. (CCH) Br. 5 & 6 at 64,264-77.

22 Fraud continues to grow despite the efforts of federal and state enforcement agencies. *Washington Post,* Jun. 4, 1984, at A-11.

defrauded investors will sue and minimizes the risk to the fraudulent promoter in the unlikely event that they do sue. Note, *Real Estate Limited Partnerships & Allocational Efficiency: The Incentive to Sue For Securities Fraud,* 63 VA. L. REV. at 671-72. One commentator described the Eighth Circuit's message to potential promoters:

> Relax. Should a violation of the securities law occur, promoters in the Eighth Circuit apparently need only assure themselves that the investors get a large enough tax deduction.

Note, *Austin v. Loftsgaarden: Securities Fraud in Real Estate Limited Partnership Investments,* 16 CREIGHTON L. REV. at 1152.

Allowing the Eighth Circuit's decision to stand encourages promoters to omit or to misrepresent information material to potential investors. Like Loftsgaarden, those promoters will hope to pocket in excess of $100,000, *see Austin II* at 963 (dissenting opinion), to keep all of the money for twelve years and then to return less than $30,000. The decision will discourage investors who look at Randall and see only a man who invested $35,000 as a result of a fraud, who spent $7,500 in loans and other thousands of dollars trying to salvage his investment and who was left with nothing but an expenditure of more than ten years and additional thousands of dollars in attorney's fees in pursuit of his recovery of $506.

This Court must insist on the disclosure required by statute. To do so, it must insure the continued viability of the express and implied remedies for violations of the

securities laws' disclosure requirements. To do otherwise is to undercut the protective purpose of the securities laws. *See* R. Thompson, *The Measure of Recovery under Rule 10b-5,* 37 VAND. L. REV. at 390 ("[f]ocusing on the defendant and resolving doubts against the party committing the fraud is consistent . . . with the dual deterrent/compensatory purposes of the federal securities laws" and requires that there be no deduction for tax benefits); *United States v. Naftalin,* 441 U.S. at 774-77.

B. Subtracting "Tax Benefits" From Securities Fraud Recoveries Effectively Transfers Monies From The Treasury To The Defrauder.

By crediting a promoter who defrauded investors with "tax benefits" conferred by the government, the Eighth Circuit makes the "government . . . the banker for fraudulent tax shelter activity." *Burgess v. Premier Corp.,* 727 F. 2d at 838. Because a defrauded purchaser's recovery is taxable, he will not retain all of it. Taxation will transfer a part of the recovery to the public treasuries from which the "tax benefits" first came.

> [T]o simply subtract the tax benefits from damages would place an unfair burden on taxpayers generally . . . . Such a result leaves the government bearing the costs of [a seller's] fraud. A better result is to set damages equal to [the defrauded purchaser's] losses exclusive of tax benefit.

Id.

In calling for enactment of the Securities Act of 1933, President Roosevelt cautioned that

> the Federal Government cannot and should not take any action which might be construed as . . . guaranteeing that newly issued securities are sound in the sense that their value will be maintained.

77 Cong. Rec. 937 (1933). The securities laws still do not guarantee the "value" of securities. However, the Eighth Circuit's

> holding provides the wrongdoer a surety by which to avoid liability, allowing the fraudulent party to use the United States Treasury for security in any fraudulent transaction. To the extent a defendant can, by his wrongful act, create a tax loss for the innocent victim, the defendant will be allowed to escape liability, shifting the burden of the loss onto the government.

Austin II at 964 (dissenting opinion). That is something neither President Roosevelt nor the Congress would ever have imagined: the government now provides a guarantee, not for the investor, but for the fraudulent promoter.

C. Subtracting "Tax Benefits" From Securities Fraud Recoveries Creates Anomalous Damage Awards.

The Eighth Circuit decision creates anomalous damage awards. Investors in different tax brackets, but identically situated in every other way, would receive awards which vary widely. The differences are based upon factors which have nothing to do with the investments or with the frauds which occasioned the awards. Even though Randall, Austin and Anderson each invested $35,000 in Alotel Associates and even though none received any cash or cash equivalent as a return on his investment, Randall is to recover $506, Austin $7,666 and Anderson $18,790. *Id.* at 961; *compare Hayden v. McDonald*, 742 F.2d 423, 425, 439 (8th Cir. 1984) (56 plaintiffs and presumably 56 different results). Disparate treatment of investors based upon differences in their taxable income undermines the

purposes of the federal securities laws. *See Herman & MacLean v. Huddleston,* 459 U.S. 375, 390 (1983) (defrauded investors are persons securities laws seek to protect).

Furthermore, the Eighth Circuit decision enables plaintiffs and defendants to manipulate the amount of damages. Because "tax benefits" depend upon an investor's ordinary income and marginal tax bracket, a plaintiff may control the timing of his receipt of ordinary income and thereby increase his damages. A defendant may also control the amount of "tax benefits" (and of damages) by his own ability to make elections. S. Banoff, *To What Extent Will Benefits from Tax Shelters be Permitted to Offset Rescission Damages,* 57 J. TAXATION 154, 155-56 (1982).

D. Subtracting "Tax Benefits" From Securities Fraud Recoveries Does Not Fully Compensate Defrauded Investors.

The Eighth Circuit held that the words "income received" in section 12(2) include all economic benefits bargained for and received, including "tax benefits."[23] *Austin II* at 955. The holding misapprehended the nature and effect of a "tax shelter."

The "tax benefits" which an investor obtains through a "tax shelter" are no more than a deferral of taxes. *Aus-*

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[23] The Eighth Circuit never considered Respondents' tax consequences. Payment of rescissionary damages will result in a business expense which can be deducted from ordinary income; actual rescission will result in a short-term capital loss. Both will result in "tax benefits" to Respondents. If the Eighth Circuit's reasoning is to be followed, Petitioners, as the ones who bestowed the "tax benefits" on Respondents, should be able to recover them from Respondents.

tin II at 963 (dissenting opinion). The district court found that Petitioners "were not actually going to make any money because of tax losses" and were getting only a tax deferral. (Pet.App.F6). Indeed, the Eighth Circuit panel recognized that Petitioners' investments in Alotel Associates served "only to defer taxation until the investment is liquidated and each partner receive[d] his . . . proportional share of the proceeds of the sale." *Austin I* at 174.

The Eighth Circuit treated "tax benefits" as "permanent" because the relevant tax years were "closed." *Austin II* at 955. The Internal Revenue Code does contain a three-year statute of limitation, 26 U.S.C. § 6501(a), and more than three years have passed, (Def.Ex.1A,1B,1C; R. 42-43,62), but the final tax consequences of the original investment and the subsequent recovery are not yet determined.

The Eighth Circuit itself acknowledges that a defrauded purchaser who recovers will be taxed on his recovery. *Austin II* at 960. At the time of recovery taxes may be imposed as a result of a purchaser's amendment of his earlier tax returns. Taxes may be imposed under the mitigation provisions of the Internal Revenue Code, which permit correction of the effect of an error even if the statute of limitation would otherwise prevent correction. 26 U.S.C. §§ 1311-14. Taxes may be imposed under the tax benefit rule's requirement that a recovery be taxed as ordinary income.

The Ninth Circuit correctly understood the consequences of a "tax shelter"; it held:

> While we agree that consideration of tax consequences is relevant for certain purposes, we decline to make the government the banker for fraudulent tax shelter

> activity. Judge Hardy's analysis in *Western Federal Corp. v. Davis*, 553 F. Supp. 818, 820 (D. Ariz. 1982) is correct in discerning that the economic benefit by way of tax deductions is illusory because amended returns will have to be filed . . . .

Id.; accord, Western Fed. Corp. v. Erickson, 739 F.2d at 1444; *Rhode v. Hershberger Explorations, Inc.*, 349 F. Supp. at 994 ("[t]o the extent recovery is had, amended income tax returns will have to be filed").

Rescission may invoke the mitigation provisions. Section 12(2) allows a defrauded purchaser to rescind. *Wigand v. Flo-Tek, Inc.*, 609 F.2d 1028, 1035 (2d Cir. 1979). Section 29(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78cc(b), declares contracts "made in violation of" section 10(b) or Rule 10b-5 to be "void." Thus, a defrauded purchaser who can demonstrate a violation of section 10(b) or Rule 10b-5 can sue for and obtain recission. *E.g., Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 387-88 (1970); *Regional Properties, Inc., v. Financial & Real Estate Consulting Co.*, 678 F.2d 552, 558 (5th Cir. 1982). Recission voids the underlying transactions from the inception and returns the parties to the *status quo ante*. *Brown v. Producers Livestock Loan Co.*, 469 F. Supp. 27, 31 (D. Utah 1978); 5C A. Jacobs, LITIGATION & PRACTICE UNDER RULE *10b-5* § 260.03 [c][vi] at 11-56.

When a "court of competent jurisdiction" enters a final "judgment, decree, or other order" which "determines the basis of property" or "of any transaction on which [the]basis [for valuing an asset] depends" and the basis is different from the basis claimed by a taxpayer, *see* 26 U.S.C. §§ 1312-13, the "effect of the error shall be corrected" despite the restriction otherwise imposed by the statute of limitation. *See* 26 U.S.C. § 1311(a). A

judgment rescinding a purchase of a "tax shelter" and declaring it void "from the inception" would be a determination of a transaction on which the purchaser's basis depended and requires correction of "the effect of the error . . . by an adjustment." *See* 26 U.S.C. § 1311(a).

The IRS may invoke the tax benefit rule. *See* 1 J. Mertens, LAW OF FEDERAL INCOME TAXATION § 7.34 at 7-115 & § 7.37 at 7-129 to -130 (1985) (taxpayer who claims deduction resulting in tax benefit one year and who obtains recovery or repayment in later year must include recovery or repayment as ordinary income in the year of recovery). Invocation of the tax benefit rule " 'eliminates' [a defrauded] purchaser's tax benefits." A. Blankenheimer, *Tax Consequences of Rescission: The Interplay Between Private & Public Law*, 42 U. CHI. L. REV. 562, 588 (1975). If the rule is invoked, "a court ordering recission has no grounds for awarding the seller an offset." *Id.*

E. A Securities Fraud Action Is Not An Appropriate Proceeding In Which To Litigate The Tax Consequences Of An Investment Induced By Fraud.

It is undisputed that Petitioners' investments in Alotel Associates and their recoveries, if any, did and will create tax consequences for them. It is also undisputed that Respondents' sales of limited partnership units and payments of judgments, if any, did and will create tax consequences for them. It is also undisputed that those tax consequences *will* be determined. However, a securities fraud action is not an appropriate proceeding in which to determine those consequences.

A number of factors indicate that a securities fraud trial is not the time to determine tax consequences. First,

the language of section 12(2), of section 10(b) and of Rule 10b-5 does not contemplate making tax adjustments. Second, this Court has indicated that, where a recovery will be subject to taxes, any adjustments should be deferred to the appropriate taxing authorities. *Hanover Shoe, Inc. v. United Shoe Mach. Corp.*, 392 U.S. at 503. Third, the collateral source rule requires that "tax benefits" not be subtracted from recoveries. Finally, the facts necessary to make a proper determination of all tax consequences of the transaction and the resulting recovery can never be known at the time of trial.

It is impossible for a trier of fact to make an accurate allocation because all necessary facts can never be known. The year in which the judgment will finally be collected is unknown. A plaintiff's income and his tax bracket in that year are unknown. A defendant's income and tax bracket in that year are unknown. The tax laws and tax rates in that year are unknown. In the face of all the uncertainty, it is impossible at the time of trial to accurately predict the tax consequences of the fraudulent sale and resulting recovery.

A speculative approximation is, of course, possible. However, it is unnecessary, and it is redundant. Congress intended the IRS and the courts to make the determinations after all the relevant facts were known. When the IRS and the courts do make those determinations, they will make them with precision and in accordance with applicable law.[24] Foisting that responsibility on triers of fact who can never have the necessary facts will yield only speculation.

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[24] No taxing authority can be bound by the result of a securities fraud action to which it is not a party. *See* A. Blankenheimer, *Tax Consequences of Rescission: The Interplay Between Public & Private Law*, 42 U. CHI. L. REV. 562.

The approach that yields mere speculation also adds substantial complexity to already complex securities law cases. The Eighth Circuit held:

> Evidence of [an IRS] audit and expert opinions as to its likely results are admissible at the retrial on damages. Certainly the possibility that past tax deductions will be disallowed is relevant to the determination of the extent of any benefit actually received by plaintiffs from those deductions. The jury is entitled to determine whether and to what extent there would be a disallowance of deductions.

Austin I at 183. Presumably, the jury will also be required to consider and determine the probability and likely outcome of IRS appeals, Tax Court or district court litigation and further judicial review.

Such a procedure creates a dilemma for the defrauded investor. Proving the weakness of his "tax shelter benefits" creates a road map for an IRS audit, but failing to offer proof reduces the damages available. D. Korn, *A Taxing Quandry: Should Investors Deprived of Shelter Sue,* BARRON'S, Jun. 17, 1985, at 39.

Section 12(2) was designed "to provide relatively easy civil relief to [defrauded] purchasers." M. Kaminsky, *An Analysis of Securities Litigation under Section 12(2),* 13 HOUSTON L. REV. at 280. The Eighth Circuit has converted it into a labyrinth.

CONCLUSION

The judgment of the Eighth Circuit should be reversed insofar as it requires "tax benefits" to be con-

strued as "income," which reduces recovery of a defrauded purchaser who rescinds pursuant to section 12(2). The judgment also should be reversed insofar as it requires "tax benefits" to offset damages under section 10(b) and Rule 10b-5. This Court should remand for the entry of judgment awarding Petitioners the consideration paid, interest on the purchase prices from the dates of purchase through the date of judgment and a reasonable attorney's fee.

Respectfully submitted,

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